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What the Tax Overhaul Means for Bay Area Financial, Life Sciences, and Technology Companies

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How a company should respond to the 2017 tax code (the "Act") changes depends on its size, structure and business strategy, among numerous other factors. Nonetheless, the industry in which a company conducts business helps leaders narrow down which provisions are most critical to understand.

The San Francisco Bay Area is home to innovative companies in nearly every industry, from transportation to telecommunications, but there's no denying that companies in the biosciences, financial services and technology sectors are especially important. Here's what business leaders in these three major Bay Area industries should know about the 2017 tax overhaul:

Changes Affecting All Businesses

Overnight, the United States went from having one of the highest corporate tax rates in the world (35 percent) to 21 percent. The new competitive flat rate puts the U.S. in the middle of the pack in the Organization for Economic Co-operation and Development. That's great news for American businesses, but it's just one change against a backdrop of revisions that companies need to consider.

The Act makes fundamental and sweeping changes to the U.S. taxation of international businesses by shifting toward a territorial system for taxing earnings of multinationals. Under the new regime, the U.S. companies will be more competitive with foreign companies. The Act removes impediments to repatriation of profits to the United States and reduces opportunities to shift income offshore to low-tax jurisdictions. This, in theory, should incentivize exports of products and services from the United States, and prevent erosion of the U.S. tax base by foreign companies.

Under the new regime, companies are provided 100 percent dividend received deduction on certain qualified dividends from foreign subsidiaries. However, the domestic corporations will need to continue to apply existing subpart F rules.

The Act will require mandatory repatriation of post-1986 undistributed foreign earnings and profits. The rate applied varies depending on whether the earnings and profits is held in liquid or non-liquid assets. A proportional deduction on the deemed repatriation will result in a so-called repatriation "toll charge" of 15.5 percent for cash and liquid assets and 8 percent for non-liquid assets. The toll charge will be assessed regardless of whether or not the company has cash in its foreign subsidiaries and regardless of whether the company brings back the earnings.

The 2017 Act introduces new provisions effective after Dec. 31, 2017. The new global intangible low-taxed income (GILTI) is the new mechanism for controlling and disincentivizing the erosion of the U.S. tax base. The GILTI inclusions will impact companies operating in low tax foreign jurisdictions that have foreign earnings generated without a large aggregate foreign fixed asset base.

Finally, the 2017 Act introduces a new minimum tax on international payments as a means to reduce the ability of multi-national companies to erode the U.S. tax base through deductible related-party payments. The minimum tax, known as the base erosion and anti-abuse tax (BEAT), is imposed when the tax calculated under BEAT exceeds the corporation's regular tax liability determined after the application of certain credits allowed against the regular tax. BEAT will significantly impact U.S. companies with royalties and management fee payments made to foreign affiliates.

Provisions like these may temper the benefits of moving parts of a business overseas. Here are some other aspects to consider:

- Deductions on qualified dividends received from other corporations have been reduced by 15-20 percent, which could affect outlooks for businesses that heavily rely on this kind of revenue.
- The 20 percent alternative minimum tax on corporate earnings has been repealed, which may serve as a major boost to some companies' profit margins.
- The tax bill altered the individual tax structure, so companies will have to consider which decisions are best in light of shareholders' income taxes.

Financial Services

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In the corporate landscape we're used to hearing about the value of leveraged buyouts. That may change thanks to revisions in net interest deductibility. The 2017 tax act essentially limits interest deductions to 30 percent of EBITDA, which may make the kind of subordinated debt currently used in leveraged acquisitions less valuable than preferred equity. Similarly, there may no longer be as much of a tax advantage to corporate debt, and highly-indebted companies may see a significant impact on their finances.

Pharmaceuticals

The pharmaceutical industry may start to experience more M&A activity among large drug and biotech companies because the move to a more territorial-based system is expected to eliminate lucrative corporate tax inversions. As a result, pharmaceutical businesses will consider bringing overseas operations back to the U.S. or rightsizing foreign operations.

Unfortunately, the new law also reduces the tax credit on clinical testing for orphan drugs — treatments exclusively developed for rare diseases — from 50 percent to 25 percent, which may make it even less sustainable to fund these expensive and financially-risky projects.

Technology

Overall, the technology, media, and telecommunications companies are likely to benefit from the new tax legislation. Tax liberalization of the capital recovery (100 percent deduction) undoubtedly will drive capital investment in property, plant and equipment. Intended to reward investment in technological innovation, the tax overhaul continues to allow for write off certain research and experimentation costs, including software development costs.

The Act changes how executive compensation is taxed. The exceptions to $1-million deduction limit for commissions and performance-based compensations have been repealed and Section 162(m) now covers a larger range of executives. Together, these changes may force companies to reconsider the kind and amount of executive compensation going forward.

Additionally, qualified employees (not including top executives) can now differ income recognition of stock in a privately-held corporation for up to five years. The election must be made within 30 days of the vesting date and the employer has federal income tax withholding and Form W-2 reporting obligations following the deferral period.

Before implementing the election, employees should consider multiple factors, including the written plan requirements, identification of eligible employees, employee notices, participation levels, FICA tax and its timing, and coordination with statutory stock options.

What You Should Do Now

This is a pivotal moment for global companies. Companies with international footprint should consider shifting or relocating manufacturing, distribution and intellectual property generating activities. Due to new expensing tax rules, companies should make additional capital investments and move or domesticate head office functions. In some cases, prior corporate inversions should also be re-considered.

Companies should review their capital and debt structure and adjust global capital, financing, and debt flows to maximize growth, minimize costs and maximize tax efficiency. Finally, companies should right-size their global workforce and attract new talent, use alternative employment arrangements, review incentive-based compensation, change or update benefits, and design new pension plans to accommodate new structure.

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